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In the Supreme Court of the United States

DAVID A. AND LOUISE A. GITLITZ, ET AL.,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Petitioners are shareholders in an insolvent Subchapter S corporation. During 1991, that corporation obtained a discharge of certain indebtedness. That discharge *would* have been treated as an item of "[i]ncome from discharge of indebtedness" (26 U.S.C. 61(a)(12)) except that, because the discharge occurred when the corporation was insolvent, the item is expressly "not include[d] * * * in gross income" under 26 U.S.C. 108(a)(1)(B). The question presented in this case is whether the amount thus expressly excluded from "income" is nonetheless to be treated as if it *were* an item of "income" which, under 26 U.S.C. 1366(a)(1)(A), flows through to petitioners as the shareholders of the Subchapter S corporation, thereby increasing their basis in the stock of the corporation under 26 U.S.C. 1367(a)(1)(A), and thereby allowing them to deduct losses they were previously unable to deduct because they had exhausted their basis by prior deductions.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-20) is reported at 182 F.3d 1143. The initial opinion of the Tax Court (Pet. App. 25-31) is unofficially reported at 73 T.C.M. (CCH) 3167. The opinion of the Tax Court on reconsideration, which withdrew and replaced the initial opinion (Pet. App. 21-24), is unofficially reported at 75 T.C.M. (CCH) 1840.

JURISDICTION

The judgment of the court of appeals was entered on July 6, 1999. A petition for rehearing was denied on November 3, 1999 (Pet. App. 32-33). The petition for a writ of certiorari was filed on February 1, 2000, and was

granted on May 1, 2000. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

Sections 108, 1366 and 1367 of the Internal Revenue Code, 26 U.S.C. 108, 1366, 1367, are set forth at Pet. App. 34-58.

STATEMENT

1. a. During the 1991 taxable year, petitioners David A. Gitlitz and Philip D. Winn each owned a 50% interest in P.D.W. & A., Inc., a Colorado corporation that elected to be taxed for that year under the provisions of Subchapter S of the Internal Revenue Code, 26 U.S.C. 1361-1379. Pet. App. 2-3. As this Court explained in *Bufferd* v. *Commissioner*, 506 U.S. 523, 525 (1993), Subchapter S of the Code implements "a pass-through system under which corporate income, losses, deductions, and credits are attributed to individual shareholders in a manner akin to the tax treatment of partnerships."

The Subchapter S corporation was a partner in a partnership that was discharged from $4,154,891 in debt during 1991. Pet. App. 3. The corporation's share of the discharged debt was $2,021,296. This amount would have represented "[i]ncome from discharge of indebtedness" to the corporation (26 U.S.C. 61(a)(12)) except that, at the time of the discharge, the corporation was insolvent.[1] Because the corporation was insolvent, this amount was expressly excluded from income under Section 108 of the Code, which specifies that "[g]ross income does not include any amount which

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[1] Prior to the discharge of indebtedness, the liabilities of the Subchapter S corporation exceeded the fair market value of its assets by $2,181,748. Pet. App. 3.

* * * would be includible in gross income by reason of the discharge * * * of indebtedness of the taxpayer if * * * the discharge occurs when the taxpayer is insolvent." 26 U.S.C. 108(a)(1)(B).[2]

b. Although Section 108 of the Code thus specifies that discharge of indebtedness is *not* an item of income for an insolvent corporation, petitioners claim that it should nonetheless be *treated* as if it were an item of income for purposes of Sections 1366 and 1367 of the Code. Those provisions determine various aspects of the tax treatment of shareholders of a Subchapter S corporation. In particular, they specify that "items of income (including tax-exempt income), loss, deduction, or credit" pass through to the shareholders (26 U.S.C. 1366(a)(1)(A)), that the "items of income" that pass through to the shareholders increase the shareholders' basis in the stock of the Subchapter S corporation (26 U.S.C. 1367(a)(1)(A)), that the losses and deductions that pass through reduce the shareholders' stock basis (26 U.S.C. 1367(a)(2)(B)), and that distributions of earnings or assets of the corporation to the shareholders reduce their basis in the stock (26 U.S.C. 1367(a)(2)(A)). The basic concepts reflected in these provisions are: (i) that the income earned (or loss incurred) at the corporate level is treated as if it were earned (or lost) at

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[2] For partnerships, the Section 108 exclusion applies "at the partner level" (26 U.S.C. 108(d)(6)) rather than at the partnership level. For Subchapter S corporations, however, the Section 108 exclusion applies "at the corporate level" (26 U.S.C. 108(d)(7)(A)) rather than at the shareholder level. When, as in this case, an insolvent S corporation is a partner in a partnership that has been discharged from debt, these provisions make the insolvency of the corporation (rather than of the partnership or of the shareholders of the Subchapter S corporation) controlling in determining whether the exclusion from income is available under Section 108.

the individual level; and (ii) that basis adjustments are made to avoid a double tax on those earnings or a double benefit from those losses.

A shareholder may deduct losses only to the extent that he has not previously recovered (through prior deductions) his basis in the stock. 26 U.S.C. 1366(d)(2). In this case, petitioners had previously deducted losses representing their entire basis in their stock. Pet. App. 3-4. At the time the indebtedness of the Subchapter S corporation was discharged in 1991, petitioners would thus be allowed further deductions from the corporate losses only if their basis in the corporate stock were somehow increased.[3]

Petitioners assert that the additional basis that they need in order to take further deductions from the losses of the Subchapter S corporation can be found in the discharge of indebtedness "income" of the corporation in 1991. They assert that this discharge of indebtedness is an "item[] of income" (26 U.S.C. 1366(a)(1)(A)) that increases their basis in the corporate stock (under 26 U.S.C. 1367(a)(1)(A)) even though, for the reasons described above, Section 108(a) of the Code expressly states that this is "*not*" an item of income. On that theory, petitioners claimed additional deductions in amounts equaling their allocable shares of the discharged debt of $2,021,296. Pet. App. 3.[4]

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[3] The losses of the corporation incurred prior to 1991, which petitioners had been unable to deduct because they had exhausted their basis, are described as "suspended" losses and are carried into future years. They may be deducted in future years only if the shareholder acquires a basis in the stock to apply against them. 26 U.S.C. 1366(d)(2).

[4] Petitioner Gitlitz claimed the deduction on his 1991 tax return, while petitioner Winn claimed the deduction on his 1992 return. Pet. App. 4 n.3.

Upon audit, the Commissioner determined that petitioners were not entitled to increase their stock basis by their reported *pro rata* shares of the discharge of indebtedness that was "not" an item of income under Section 108 of the Code. The Commissioner therefore disallowed the deductions claimed by petitioners and asserted a deficiency of $251,192 against petitioner Gitlitz and of $242,555 against petitioner Winn. Pet. App. 64-66, 81-83.

2. Petitioners filed separate petitions in the Tax Court that were consolidated for disposition. On cross-motions for summary judgment, the Tax Court initially ruled in favor of petitioners. Pet. App. 25-31. The court stated (*id.* at 29-30) that, because income from the discharge of indebtedness is an item of income in the general definition of gross income (26 U.S.C. 61(a)(12)), it qualifies as an "item[] of income" for which an upward basis adjustment is appropriate under 26 U.S.C. 1366(a)(1)(A) even though, due to the insolvency of the debtor, it is excluded from income under Section 108(a)(1)(B).

The Commissioner moved for reconsideration. While that motion was pending, the entire Tax Court held in a reviewed decision that a discharged debt that is excluded from a Subchapter S corporation's gross income because of its insolvency does *not* constitute an item of "income" that would increase the shareholder's basis in the corporate stock (and thereby allow deductions of losses after that basis has been exhausted by prior deductions). *Nelson* v. *Commissioner*, 110 T.C. 114 (1998), aff'd, 182 F.3d 1152 (10th Cir. 1999). Relying on its decision in *Nelson*, the Tax Court then granted the motion for reconsideration in this case and entered decisions in favor of the Commissioner. Pet. App. 21-24.

3. The Tenth Circuit affirmed. Pet. App. 1-20.[5] The court of appeals emphasized that petitioners' proposed interpretation of the Code would accomplish an inappropriate double tax benefit for taxpayers: it would permit the insolvent Subchapter S corporation to avoid tax on the discharged debt (an item that is "not" treated as an item of income for insolvent corporations under Section 108(a)) but, at the same time, allow the shareholders of the corporation to reduce their gross income from *other* sources by treating the discharged debt as if it *were* an item of "income," thereby increasing their basis in the corporate stock and permitting deductions otherwise barred by the prior exhaustion of that basis. Pet. App. 10. The court noted that this Court has emphasized that the Internal Revenue Code "should not be interpreted to allow taxpayers the practical equivalent of a double deduction absent a clear declaration of intent by Congress." *Ibid.* (quoting *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 684 (1969)). The court concluded that "only if taxpayers' theory is unequivocally supported by the statutory text may we adopt it here" (Pet. App. 10) and held that petitioners did not meet that burden in this case.

The court noted that a discharge of indebtedness does not constitute an item of income under Section 108(a) if "the debt is discharged in a bankruptcy proceeding or at a time when the taxpayer is insolvent" (Pet. App. 9) and that this characterization of the item

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[5] The taxpayer in *Nelson* v. *Commissioner* also appealed the Tax Court's decision in that case to the Tenth Circuit. The court of appeals affirmed the Tax Court's decision on the authority of its opinion in this case. *Nelson* v. *Commissioner*, 182 F.3d 1152 (10th Cir. 1999). The taxpayer in *Nelson* did not file a petition for a writ of certiorari.

is necessarily made and "applied at the *corporate* level" (*id.* at 11 (citing 26 U.S.C. 108(d)(7)(A)). See note 2, *supra*. The court explained that petitioners' effort nonetheless to treat it as an "item[] of income" under Section 1366 ignores and "effectively eliminate[s] the 'price' Congress imposed upon entities whose discharged debt income is excluded under § 108." Pet. App. 13. That "price" is set forth in Section 108(b), which requires the insolvent corporation to reduce various "tax attributes" (such as carried over credits or losses) "that could otherwise yield future tax benefits." *Id.* at 9. In deciding in Section 108 to "not" treat a discharge of debts owed by an insolvent as "income," Congress did not mean to provide additional tax benefits to the corporate shareholders in the manner proposed by petitioners; instead, Congress determined in Section 108(b) to reduce the preexisting tax carryforwards available to the corporation that might yield "future tax benefits." Pet. App. 9. The court concluded that petitioners' interpretation of these statutes "would negate the effect of the tax attribution scheme and would give [petitioners] an unwarranted windfall." *Id.* at 16.[6]

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[6] The court of appeals provided several examples that illustrate the interplay among Sections 108, 1366 and 1367. Pet. App. 16-18 n.6. The court noted that the amount excluded from an insolvent S corporation's gross income under Section 108 can not pass through to its shareholders to increase their basis under Sections 1366 and 1367 because: (i) the debt discharge amount is first applied to reduce the corporation's favorable tax attributes (including any suspended shareholder losses which, under Section 108(d)(7)(B), are treated for this purpose as net operating losses of the Subchapter S corporation); and (ii) "[a]ny further remaining debt discharge amount is [to be] disregarded, i.e., does not result in income or have other tax consequences." Pet. App. 9 (quoting S. Rep. No. 1035, 96th Cong., 2d Sess. 2 (1980)).

SUMMARY OF ARGUMENT

Long prior to the enactment of the provisions of the Internal Revenue Code involved in this case, judicial decisions and Treasury rulings had both made clear that a discharge of indebtedness does *not* constitute an item of "income" for an insolvent corporation. In enacting Section 108 of the Code in 1980, Congress embraced and codified that established rule by expressly providing that the discharge of a debt does "not" constitute income to an insolvent taxpayer. 26 U.S.C. 108(a)(1)(B). Congress nonetheless determined, however, that it was appropriate to impose a price for this economic benefit for insolvent taxpayers by requiring them to use the amount of such discharged debt to reduce or eliminate certain favorable "tax attributes" that they otherwise could employ to reduce their taxable income in future years. 26 U.S.C. 108(b)(1)-(2). For insolvent Subchapter S corporations, those tax attributes include the "suspended" corporate losses that the shareholders were unable to deduct because they lacked sufficient basis in the stock of the corporation. Under Section 108(d)(7)(B) of the Code, such losses are treated as "net operating losses" of the corporation and any amount of discharged debt of insolvent Subchapter S corporations is to be set off against those losses to reduce or eliminate them. As the legislative history of Section 108 clearly states, "[a]ny further remaining debt discharge amount is [then to be] disregarded, i.e., does not result in income or have other tax consequences." S. Rep. No. 1035, 96th Cong., 2d Sess. 2, 13 (1980).

In this case, petitioners' insolvent S corporation was discharged from a debt in 1991. Petitioners contend that the debt discharge to that insolvent corporation—an item that has never been regarded as an item of

"income" in the lengthy history of the federal income tax and that Congress expressly specified is "not" income to the corporation in enacting Section 108(a)(1)(B)—is nonetheless an "item[] of income" of the corporation within the meaning of Section 1366(a)(1)(A) that increases shareholder stock basis under Section 1367(a)(1)(A) and thereby allows petitioners to take deductions for losses "suspended" under Section 1366(d)(1) for lack of basis. The courts that have considered petitioners' contention have recognized that petitioners are seeking to obtain the "windfall" of a double tax benefit from the debt discharge: they would avoid payment of tax on the amount that is "not" treated as an item of income under Section 108 and would also obtain an upward basis adjustment for their corporate stock under Section 1367 that would enable them to deduct otherwise nondeductible losses.

Petitioners' argument conflicts with the plain language of the provisions of Sections 1366 and 1367 that limit basis adjustments to "items of income" received by the corporation. Their contention would also nullify the statutory mandate (in Sections 108(b)(2)(A) and 108(d)(7)(B)) that the amount of discharged debt that is "not" an item of income for the insolvent corporation is to be applied to reduce (or eliminate) the very suspended corporate losses (and other favorable tax attributes of the corporation) that petitioners seek instead to deduct. Petitioners thus seek to obtain a double tax benefit in a context where Congress plainly sought to reduce the benefit, not double it. The erroneous interpretation of these provisions for which petitioners contend would improperly transmute a statute that was designed as a method of deferring the tax on debt forgiveness into a mechanism for avoiding tax on the

unrelated income of shareholders of insolvent S corporations.

ARGUMENT

THE AMOUNT OF DEBT DISCHARGED FOR AN INSOLVENT SUBCHAPTER S CORPORATION IS NOT AN ITEM OF "INCOME" THAT FLOWS THROUGH TO THE SHAREHOLDERS OF THE CORPORATION UNDER SECTION 1366(a) OR INCREASES THEIR BASIS IN THE STOCK OF THE CORPORATION UNDER SECTION 1367(a)

A. The Discharge Of A Debt Is Not An Item Of "Income" To An Insolvent Corporation

The intricate and interrelated tax statutes involved in this case are best understood in the context of the unique history in which they were developed and enacted. Long prior to the enactment of the provisions of the Internal Revenue Code involved in this case, judicial decisions and Treasury rulings had uniformly concluded that a discharge of indebtedness does *not* constitute an item of "income" for an insolvent corporation. In enacting Section 108 of the Code in 1980, Congress embraced and codified that established rule by specifying that the discharge of a debt does "not" constitute income to an insolvent taxpayer. 26 U.S.C. 108(a)(1)(B). Since the debt discharge of an insolvent corporation does not give rise to "income," there is no "item of income" that passes through to the shareholders to increase their basis under Sections 1366 and 1367.

1. The concept of "income" has a "sweeping scope" and is broad enough to include all "accessions to wealth." *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 429, 431 (1955). In 1931, this Court held in

United States v. *Kirby Lumber Co.*, 284 U.S. 1, that a *solvent* taxpayer realizes "income" from the discharge of indebtedness. The Court reasoned that the taxpayer made a "clear gain" when it repurchased for a lesser amount bonds that it had issued at par, for it thereby "made available * * * assets previously offset by the obligation of bonds now extinct." *Id.* at 3. As the Court has further explained, a solvent taxpayer realizes "income" when he is "released from his obligation to repay" a debt, for he "enjoys a net increase in assets equal to the forgiven portion of the debt * * * ." *United States* v. *Centennial Savings Bank FSB*, 499 U.S. 573, 582 (1991). In adding Section 61(a)(12) to the Code in 1954, Congress codified the result of these decisions by specifying that gross income includes "[i]ncome from discharge of indebtedness." 26 U.S.C. 61(a)(12).

Notwithstanding the facial breadth of this statute, the Treasury Department and the courts have uniformly concluded that a discharge of indebtedness does *not* constitute "income" for an *insolvent* corporation. In adopting what became known as the judicial "insolvency exception" to the tax rules governing the treatment of the discharge of indebtedness, the courts explained that the rationale of *Kirby Lumber* does not apply to a taxpayer who is insolvent at the time the debt is discharged and remains so afterward.[7] See, *e.g.*, *Dallas Transfer & Terminal Warehouse Co.* v.

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[7] Although the conclusion that an insolvent taxpayer realizes no income from the discharge of indebtedness has been referred to as the "judicial insolvency exception," the exception originated in a 1923 Treasury ruling (I.T. 1564, II-1 C.B. 59 (1923)) that was confirmed by Treasury regulations adopted as recently as 1957. See 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 7.6.1, at 7-56 n.1 (3d ed. 1999).

Commissioner, 70 F.2d 95, 96 (5th Cir. 1934); *Astoria Marine Construction Co.* v. *Commissioner*, 12 T.C. 798, 801 (1949) (collecting cases). These courts held that the forgiveness of a debt does not represent "income" for an insolvent taxpayer because, unlike the solvent taxpayer in *Kirby Lumber*, an insolvent taxpayer does not experience an increase or "freeing up" of any assets by reason of the discharge. *Dallas Transfer & Terminal Warehouse Co.* v. *Commissioner*, 70 F.2d at 96; see 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 6.4.6, at 6-58 n.97 (2d ed. 1989). The court explained in *Dallas Transfer & Terminal Warehouse Co.* v. *Commissioner*, 70 F.2d at 96, that, when an insolvent is discharged from debt, no "income" is realized because the insolvent does not "acquir[e] something of exchangeable value in addition to what [it] had before. * * * There is an absence of such a gain or profit as is required to come within the accepted definition of income." As the Tax Court stated in *Astoria Marine Construction Co.* v. *Commissioner*, 12 T.C. at 801, when the "remaining obligations" of the insolvent taxpayer continue to exceed its remaining assets, no "income" is realized from the discharge of a debt because "no assets were freed from the claims of creditors by [the] discharge."

Even after Congress added Section 61(a)(12) to the Code in 1954 specifically to enumerate "[i]ncome from discharge of indebtedness" as an item of "income" (26 U.S.C. 61(a)(12)), the Treasury confirmed in implementing regulations that the longstanding judicial "insolvency exception" remained in force. 26 C.F.R. 1.61-12(b)(1). Since 1957, this regulation has specified that "[i]ncome is not realized by a taxpayer" by the discharge of his indebtedness "if immediately thereafter

the taxpayer's liabilities exceed the value of his assets." *Ibid.* See T.D. 6272, 1957-2 C.B. 18, 31.[8]

2. In 1980, Congress embraced and codified this well-established "insolvency exception" by specifying in Section 108(a) of the Code that the discharge of a debt does "not" constitute an item of "income" to an insolvent taxpayer. 26 U.S.C. 108(a)(1)(A). This provision was enacted as part of the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2, 94 Stat. 3389. In enacting that legislation, Congress noted that, while "[u]nder present law, income is realized when indebtedness is forgiven, * * * [t]here are several exceptions to the general rule." S. Rep. No. 1035, *supra*, at 8. In particular, "[u]nder a judicially developed 'insolvency exception,' *no income arises from discharge of indebtedness if the debtor is insolvent* both before and after the transaction." *Ibid.* (emphasis added).

In codifying this longstanding "insolvency exception," Section 108(a) of the Code specifies that "[g]ross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge * * * of indebtedness of the taxpayer if * * * the discharge occurs when the taxpayer is insolvent." 26 U.S.C. 108(a)(1)(B).[9] At the

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[8] This regulation confirmed the ruling issued in 1923, in which the Treasury Department first expressed the conclusion that the discharge of indebtedness does *not* constitute an item of "income" to an insolvent entity. See note 7, *supra*.

[9] The amount of discharged debt that does not represent "income" under Section 108(a)(1)(B) may not exceed the amount by which the taxpayer is insolvent. 26 U.S.C. 108(a)(3). Section 108(d)(3) defines the term "insolvent" as "the excess of liabilities over the fair market value of assets," and provides that insolvency is to "be determined on the basis of the taxpayer's assets and

same time, however, Congress determined that it was appropriate to impose a price for this preferential treatment of insolvent taxpayers—a price that had *not* been imposed under the judicial "insolvency exception." See 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 7.6.3, at 7-58 (3d ed. 1999), The price that Congress imposed is the requirement added by Section 108(b) that the taxpayer must use the amount of the discharged debt to reduce or eliminate certain favorable "tax attributes" that the taxpayer could otherwise employ to reduce its taxable income in future years. 26 U.S.C. 108(b)(1), (2).[10] The favorable

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liabilities immediately before the discharge." 26 U.S.C. 108(d)(3). Section 108 provides the same treatment for the discharge of a debt in a bankruptcy case and for the discharge of "qualified farm indebtedness." 26 U.S.C. 108(a)(1)(A), (C).

[10] Under Section 108(b)(1), the amount excluded from gross income under Section 108(a)(1) "shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2)." 26 U.S.C. 108(b)(1). Section 108(d)(7)(A) prescribes that, in the case of discharge of indebtedness by a Subchapter S corporation, Sections 108(a) and 108(b) "shall be applied at the corporate level." 26 U.S.C. 108(d)(7)(A).

Under Section 108(b)(2), the amount excluded under Section 108(a)(1) is generally applied to reduce the following tax attributes in the following order: (i) any net operating loss for the taxable year of the discharge and any net operating loss carryover to the taxable year of the discharge, (ii) a general business credit, (iii) capital loss carryovers, (iv) the basis of property of the taxpayer, and (v) foreign credit tax carryovers. 26 U.S.C. 108(b)(2)(A)-(G). The reductions are dollar for dollar for net operating losses, capital loss carryovers and basis reduction, and 33.33 cents for each dollar excluded under Section 108(a) for the general business credit and foreign tax credit carryovers. 26 U.S.C. 108(b)(3)(A) & (B). Section 108(d)(7)(B) defines the "net operating loss" of a Subchapter S corporation, for the purposes of Section 108(b)(2)(A), to include "any loss or deduction which is disallowed for the taxable year of

"tax attributes" that Congress specified are to be reduced by the amount of the discharged debt include the insolvent's net operating losses, its basis in property, its capital loss carryovers, and other specific items set forth in the detailed provisions of Section 108(b). See note 10, *supra*. In enacting this provision in 1980, Congress clearly stated its understanding and intent that any portion of the debt discharge amount remaining *after* application against these specified tax attributes was then to be "disregarded, i.e., *does not result in income or have other tax consequences.*" S. Rep. No. 1035, *supra*, at 2, 13 (emphasis added).[11] As Professors Bittker and Lokken have explained, when the favorable tax attributes of the insolvent corporation are insufficient to absorb all of the debt discharge amount, "the unabsorbed amount is not gross income" and is therefore to be "ignored." 1 B. Bittker & L. Lokken, *supra*, at 7-58.[12]

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the discharge under section 1366(d)(1)." 26 U.S.C. 108(d)(7)(B). The "suspended" losses of the shareholders, which can not be deducted due the exhaustion of their basis in the corporate stock, are thereby defined as a "net operating loss" of the corporation for tax attribution reduction under Section 108(b).

Under Section 108(b)(5), the taxpayer may elect to apply any portion of the reduction referred to in Section 108(b)(1) to reduce "the basis of the depreciable property of the taxpayer." 26 U.S.C. 108(b)(5). Section 1017(a)(2) provides that "such portion shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs." 26 U.S.C. 1017(a)(2).

[11] Congress provided in Section 108(e)(1) that "[e]xcept as otherwise provided in this section, there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness." 26 U.S.C. 108(e)(1).

[12] "In this situation, §§ 108(a) and 108(b) preserve an anomaly from the law predating their enactment in 1980, when a bankrupt

By thus using the amount of the discharge of indebtedness that does *not* represent an item of "income" for an insolvent taxpayer to reduce certain prospectively favorable tax attributes of the taxpayer, Congress sought to employ Section 108 as a tax-deferral, rather than a tax-forgiveness, mechanism: the taxpayer avoids immediate payment of tax from the debt discharge but pays potentially greater taxes in future years as a result of the discharge. "[T]he rules of the [statute] are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge." S. Rep. No. 1035, *supra*, at 10. As this Court stated in *United States* v. *Centennial Savings Bank FSB*, 499 U.S. 573 (1991), "the effect of § 108 is not genuinely to exempt such income from taxation, but rather to defer the payment of the tax by reducing the taxpayer's" ability prospectively to employ any favorable tax attributes existing at the time the discharge occurred. *Id.* at 580.[13]

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or insolvent taxpayer was excused from recognizing debt discharge income and suffered no collateral consequence." 1 B. Bittker & L. Lokken, *supra*, at 7-58.

[13] The 1980 amendments to Section 108 had no specific provisions for Subchapter S corporations. The statute, however, provided special rules for applying the provisions of Section 108(a) and (b) to partnerships. Section 108(d)(6) provided (and continues to provide) that the exclusion from gross income (in Section 108(a)) and the reduction in tax attributes (in Section 108(b)) occur "at the partner level." 26 U.S.C. 108(d)(6). See note 2, *supra*.

In the Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 3(e), 96 Stat. 1689, Congress amended Section 108(d)(6) to provide that, in the case of S corporations, the exclusion from gross income and the reduction in tax attributes were to occur at the shareholder level, thereby treating S corporations and partnerships similarly. In 1984, however, Congress altered that result by

B. The Discharge Of A Debt Of An Insolvent Subchapter S Corporation Is Not An Item Of "Income" Or "Tax Exempt Income" That Flows Through To Shareholders And Increases Their Basis In The Corporate Stock Under Sections 1366 And 1367 Of The Code

Although Section 108 of the Code thus adopts the longstanding rule that a discharge of indebtedness is *not* an item of income for an insolvent corporation, petitioners claim that such a discharge should nonetheless be *treated* as if it were an item of income for purposes of Sections 1366 and 1367 of the Code. Those provisions determine various aspects of the tax treatment of shareholders of Subchapter S corporations. In particular, they specify that "items of income (including tax-exempt income), loss, deduction, or

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enacting Section 108(d)(7), which provides that, for Subchapter S corporations, (i) the exclusion and the attribute reduction are to take place at the corporate level and (ii) that any shareholder loss disallowed for the year of the discharge under Section 1366(d)(1) is, for purposes of tax attribute reduction under Section 108(b), to be treated as a net operating loss of the corporation for that year. Tax Reform Act of 1984, Pub. L. No. 98-369, § 721(b), 98 Stat. 966. The purpose of the 1984 amendment is "to treat all shareholders in the same manner" (H.R. Rep. No. 432, 98th Cong., 1st Sess. 334 (1983)) by making "the exclusion of income arising from discharge of indebtedness and the corresponding reductions in tax attributes (including losses which are not allowed by reason of any shareholder's basis limitation) [operate] at the corporate level." *Ibid.* The 1984 amendment "t[ook] effect as if included in the Subchapter S Revision Act of 1982" (Pub. L. No. 98-369, § 721(y)(1), 98 Stat. 972), and the 1982 provisions that would have made the exclusion and attribute reduction operative at the shareholder level were thus never effective. Petitioners' citation (Pet. Br. 27) of the provisions of the former Section 108(d)(6)—provisions that Congress rejected and that were never applicable for Subchapter S corporations—is thus plainly incorrect.

credit" pass through to the shareholders (26 U.S.C. 1366(a)(1)(A)), that the "items of income" that pass through to the shareholders increase the shareholders' basis in the stock of the Subchapter S corporation (26 U.S.C. 1367(a)(1)(A)), that the losses and deductions that pass through reduce the shareholders' stock basis (26 U.S.C. 1367(a)(2)(B)), and that distributions of earnings or assets of the corporation to the shareholders reduce their basis in the stock (26 U.S.C. 1367(a)(2)(A)).

At the time the indebtedness of the Subchapter S corporation involved in this case was discharged in 1991, petitioners had previously deducted losses representing their entire basis in the stock. Pet. App. 3-4. They would thus be allowed further deductions from the corporate losses only if their basis in the corporate stock were somehow increased. 26 U.S.C. 1366(d)(2). Petitioners contend that the debt discharge of their insolvent Subchapter S corporation—a discharge that is "not" an item of income under Section 108—is nonetheless to be treated as if it were an "item of income" of the corporation within the meaning of Section 1366(a)(1)(A), which would increase their basis in the corporate stock under Section 1367(a) and allow them to take deductions for losses "suspended" when they had previously exhausted their basis by taking other loss deductions. The court of appeals correctly rejected that claim.

1. Petitioners improperly seek to characterize an item as "income" when Congress has instead specified that it is "not" income. 26 U.S.C. 108(a). As all of the courts that have considered this issue have observed, petitioners' application of this statutory text would accomplish a double tax benefit from the discharged debt of the Subchapter S corporation: their inter-

pretation would not only avoid payment of any tax on the discharged debt but it would also yield an upward basis adjustment for the corporate stock equal to that amount, which would enable petitioners to deduct "suspended" corporate losses against any unrelated income received by petitioners from other sources.[14] Petitioners thus seek to *obtain* a tax benefit from a statute that was enacted by Congress to *reduce or eliminate* tax benefits. In short, petitioners would transmute a statute that was designed as a method of *deferring* the tax on debt forgiveness into a mechanism for *avoiding* tax on unrelated income of shareholders of insolvent Subchapter S corporations. In addressing the defects in petitioners' erroneous parsing of these statutory provisions, it is therefore appropriate to note the wisdom of the advice of eminent tax counselors that "the lawyer's passion for technical analysis of the statutory language should always be diluted by distrust of a result that is too good to be true." B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 14.51, at 14-170 (5th ed. 1987).

a. To begin with, it is incorrect to characterize the discharge of a debt as giving rise to "income" for an insolvent taxpayer. Neither the statute nor the applicable court decisions or administrative rulings characterize the discharge of debt for an insolvent corporation as an item of "income." For decades prior to the enactment of the Bankruptcy Tax Act of 1980, including many years after Section 61(a)(12) of the Code was enacted generally to include "[i]ncome from dis-

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[14] As the court stated in *Pugh* v. *Commissioner*, 213 F.3d 1324, 1330 (11th Cir. 2000), petitioners' reasoning "can lead to the result that shareholders actually benefit from their S corporation's insolvency."

charge of indebtedness" in gross income, the Treasury and the courts had consistently ruled that a discharge of indebtedness for an insolvent taxpayer does not "come within the accepted definition of income." *Dallas Transfer & Terminal Warehouse Co.* v. *Commissioner*, 70 F.2d at 96. See pages 10-13 & note 7, *supra*. In enacting Section 108, Congress endorsed and codified this preexisting, established rule that "*no income arises* from discharge of indebtedness if the debtor is insolvent." S. Rep. No. 1035, *supra*, at 8 (emphasis added). Moreover, in providing in Section 108 that an insolvent taxpayer's debt discharge is "not" income (26 U.S.C. 108(a)(1)(B)), Congress emphasized that any debt discharge amount remaining after application against the tax attributes set forth in the statute is to be "disregarded" because it "*does not result in income or have other tax consequences.*" S. Rep. No. 1035, *supra*, at 2 (emphasis added). See also *id.* at 13 (same).

In requiring in Section 108(b) that the insolvent corporation apply the amount of such forgiven indebtedness to *reduce* its favorable tax attributes (see note 10, *supra*), Congress plainly did not intend to transform the discharge amount into an "item of income" that would flow through to the taxpayer and *enhance* its favorable tax attributes under Section 1366(a)(1)(A). Instead, any discharge amount remaining after application against favorable tax attributes is to be "disregarded" because "the unabsorbed amount is not gross income" and is therefore to be "ignored." 1 B. Bittker & L. Lokken, *supra*, at 7-58. See note 12, *supra*.

In view of this clear legislative history, petitioners' disregard of the plain, limiting text of this statute is fatal to their claim. It is an established "rule that tax-exemption and -deferral provisions are to be construed

narrowly" (*United States* v. *Centennial Savings Bank FSB*, 499 U.S. at 583) and that "the Code should not be interpreted to allow [taxpayers] 'the practical equivalent of double deduction * * * .'" *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 684 (1969) (quoting *Charles Ilfeld Co.* v. *Hernandez*, 292 U.S. 62, 68 (1934)).

b. Petitioners also err in contending (Pet. Br. 47-48), in the alternative, that the discharge of the debt of an insolvent taxpayer constitutes an item of "tax exempt income" that would flow through to the shareholders under Section 1366(a) and increase their basis under Section 1367(a). The most fundamental reason why the amount of a discharged debt of an insolvent is not "tax exempt income" is that this amount does not represent "income" of any type.[15] Unlike "tax exempt income" (such as state and local bond interest) which represents an "undeniable accession[] to wealth" (*Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. at 431) and thus plainly

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[15] The decision of the Third Circuit in *United States* v. *Farley*, 202 F.3d 198, 209 (2000), petition for cert. pending, No. 99-1675, and of the Eleventh Circuit in *Pugh* v. *Commissioner*, 213 F.3d at 1331, erred in this regard by equating the discharged debt of an insolvent under Section 108 with the category of "tax-exempt income" that passes through to shareholders to increase their stock basis under Sections 1366 and 1367. The court in *Pugh* did so reluctantly, for it "acknowledge[d] the justice of the Commissioner's position, for unlike other sources of tax-exempt income, [debt discharge] income becomes tax-exempt merely from the infelicitous combination of corporate insolvency and a lack of tax attributes to offset the [debt discharge] income [under Section 108(b)]." 213 F.3d at 1331. What these courts failed to recognize, however, is that the debt discharge of an insolvent is not only not "tax-exempt income," it is not an item of "income" at all. See S. Rep. No. 1035, *supra*, at 8 ("no income arises from a discharge of indebtedness if the debtor is insolvent"); 1 B. Bittker & L. Lokken, *supra*, at 7-58; pages 10-13 & note 7, *supra*.

constitutes "income," the amount of a discharged debt of an insolvent has not been regarded as yielding an accession to wealth and has instead consistently been held by the courts and the Treasury *not* to come within the definition of "income" at all. See pages 10-13 & note 7, *supra*. In enacting Section 108, Congress adopted—it did not alter or discard—the established rule that the discharged debt of an insolvent is simply "not" an item of "income" of any type. 26 U.S.C. 108(a). See S. Rep. No. 1035, *supra*, at 2, 8.

Moreover, although "[t]here is no definition of 'tax-exempt' for purposes of section[ ] 1366," the term inherently signifies an item that is "exempt on a permanent basis." *Nelson* v. *Commissioner*, 110 T.C. at 125. The statutory provisions that concern "tax-exempt income" address items such as life insurance proceeds and state and local bond interest, which not only are excluded from income in the year received (26 U.S.C. 101, 103) but also are *not* accompanied with the offsetting reductions in tax attributes that make debt discharge income "subject to taxation in the future." 110 T.C. at 125. As this Court explained in *Centennial Savings Bank*, due to the offsetting adjustments of tax attributes required for debt discharge items under Section 108, the result of the statute "is not genuinely to exempt such income from taxation * * *." 499 U.S. at 580.[16]

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[16] In 1999, the Treasury Department promulgated Treas. Reg. 1.1366-1(a)(2)(viii). That regulation formally specifies that the amount of any discharge of indebtedness of an insolvent Subchapter S corporation is *not* "tax-exempt income" within the meaning of the basis adjustment rules of Sections 1366 and 1367. 64 Fed. Reg. 71,641 (Dec. 22, 1999). The regulation is effective only for taxable years beginning on or after August 18, 1998, and thus does not, by its terms, apply to this case. 26 C.F.R. 1.1366-5.

When tax exempt items—such as life insurance proceeds and state or local bond interest—are received by a Subchapter S corporation and passed through to its shareholders under Section 1366(a)(1)(A) as "items of income (including tax-exempt income)," the shareholders receive an *upward* basis adjustment (under Section 1367(a)(1)(A)) that is offset by a corresponding *downward* basis adjustment (under Section 1367(a)(2)(A)) when that income is distributed to the shareholder. 26 U.S.C. 1367(a)(2)(A). See pages 3-4, *supra*. As the Tenth Circuit explained in this case (Pet. App. 8-9), the temporary basis increase under Section 1367 for these items of "tax-exempt income" is logically required to preserve the tax-exempt character of the income at the shareholder level. In the absence of that basis increase, the shareholder would be subject to tax upon the distribution of the income under Section 1368(b)(2) of the Code, for any distribution of cash or property that exceeds a shareholder's adjusted basis in stock is treated as gain from the sale or exchange of property. 26 U.S.C. 1368(b)(2).

By contrast, as the Treasury Department and the courts have long recognized, when an insolvent is discharged from debt, the corporation acquires no asset for distribution in cash or in kind to its shareholder. Because the corporation is insolvent, "there is a reduction or extinguishment of liabilities without any increase of assets." *Dallas Transfer & Terminal Warehouse* Co. v. *Commissioner*, 70 F.2d at 96. If (as petitioners contend) an upward basis adjustment occurred under Section 1367 in this context, it would thus *not* be followed by a corresponding downward basis adjustment, for there is no "distribution" associated with the

discharge of an insolvent corporation's indebtedness.[17] An upward basis adjustment in this context would serve no purpose other than to defeat the plain mandate of Congress that the discharge of indebtedness is "not" to be treated as "income" to an insolvent corporation (26 U.S.C. 108(a)(1)(B)) and that any amount of the discharged debt remaining after application against the taxpayer's favorable tax attributes under Section 108(b) has no "tax consequences" and is simply to be "disregarded" (S. Rep. No. 1035, *supra*, at 2, 13).

c. Petitioners incorrectly assert (Pet. Br. 18-21, 46) that Treasury regulations have characterized the debt discharge of an insolvent Subchapter S corporation as giving rise to "tax-exempt income." The brief portion of the regulations cited by petitioners simply paraphrases the statutory basis adjustment for "tax-exempt income" (26 U.S.C. 1366(a)(1)(A)) as an adjustment that applies to "nontaxable item[s]" of income (26 C.F.R. 1.1367-1(d)(2)). Nothing in that abbreviated regulatory language purports to alter or enlarge the statutory text. The regulation merely employs a phrase that is similar, but not identical, to the statutory language in describing its effect.

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[17] Petitioners thus plainly err in arguing (Pet. Br. 47-49) that the treatment they seek for debt discharge of an insolvent taxpayer has no different consequence than the treatment of "tax exempt income" such as state and local bonds. The treatment of "tax exempt income" such as state and local bonds simply preserves the statutory exemption for those items of "income"; the treatment sought by petitioners for debt discharge of an insolvent taxpayer would create an addition to basis (and thereby permit additional deductions) for which no offsetting item of "income" exists. Indeed, it is through this very mechanism that petitioners seek to obtain a double tax benefit from the operation of these provisions. See, *e.g.*, Pet. App. 10; note 14, *supra*.

In particular, nothing in that regulation purports to conclude that the discharge of indebtedness of an insolvent Subchapter S corporation provides a basis adjustment for the shareholders of the corporation under Sections 1366 and 1367. That issue is not even remotely addressed in that regulation. There is, however, a different regulation—a regulation that petitioners have failed to cite—that actually *is* relevant to that issue. Since 1957, the Treasury has specified in its regulations that "[i]ncome is not realized" from the discharge of the debt of an insolvent. 26 C.F.R. 1.61-12(b)(1). This regulation conforms to the longstanding principle that the discharge of a debt of an insolvent does not represent an item of "income" of any type. See pages 10-13 & note 7, *supra*. By contrast, "tax-exempt income" is an item of actual "income" that a taxpayer has actually "realized," but that Congress has chosen, by statute, to exempt from tax. Section 108 does not make the discharge of indebtedness of an insolvent "exempt" from tax, for that item was never "income" subject to tax in the first place. See S. Rep. No. 1035, *supra*, at 8 ("no income arises from discharge of indebtedness if the debtor is insolvent").

Petitioners' reliance (Pet. Br. 21-22) on a similar abbreviated paraphrasing of the scope of the basis adjustment for "tax-exempt income" in the legislative history of the Subchapter S Revision Act of 1982 provision is inapposite for precisely these same reasons. Moreover, in describing these same statutory provisions in 1993, Congress stated its clear understanding that "[t]he shareholders' basis in their stock is *not* adjusted" by the amount of a discharged debt of an insolvent Subchapter S corporation. H.R. Rep. No. 111, 103d Cong., 1st Sess. 624-625 (1993) (emphasis added). That legislative state-

ment is, of course, precisely at odds with the interpretation of these provisions advocated by petitioners.[18]

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[18] Petitioners further err in claiming (Pet. Br. 46) that a Technical Advice Memorandum (T.A.M. 97-39-002) issued by the Internal Revenue Service in 1997 supports their position. This Technical Advice Memorandum serves as internal advice within the agency, and Congress has specified that such documents "may not be used or cited as precedent." 26 U.S.C. 6110(k)(3). In any event, the ruling contained in this Memorandum concerns partnership provisions that have no relevance to this case. The ruling addresses the fact that the insolvency rules for the discharged debt of a partnership are applied at the individual partner level (26 U.S.C. 108(d)(6)), whereas the insolvency rules for the discharged debt of a Subchapter S corporation are instead applied at the corporate level (26 U.S.C. 108(d)(7)). Income from the discharge of a partnership debt is therefore first allocated to each partner and tested *at the partner level* to determine whether the insolvency of a partner would require elimination of that item in the determination of the partner's individual tax obligations. An initial basis adjustment is therefore made under Section 702(a) to reflect the allocation of the debt discharge item to the individual partner; that adjustment is then offset by a reduction of basis under Section 733 and 752(b) to reflect the reduction in the partner's liability for partnership debts. If the partner's insolvency precludes recognition of the discharged debt as an item of income, that is to be treated separately on the partner's return and does not affect the calculation of the partner's basis in the partnership. 1997 WL 592925 (IRS TAM 97-39-002) at 2-3. These partnership adjustments made at the partner level under 26 U.S.C. 705 (see 26 U.S.C. 108(d)(6)) obviously have no direct relevance for application of the statutory provisions involved in this case, which require that the treatment of discharged debt of insolvent Subchapter S corporations be determined "at the corporate level" (26 U.S.C. 108(d)(7)) and that provide basis adjustments for any resulting item of "income" under 26 U.S.C. 1336 and 1367. Under the partnership rules and the Subchapter S rules, however, the final result will be the same: a debt discharge for an insolvent partner or for an insolvent Subchapter S corporation does not ultimately constitute an item of income *for the partners or for the*

2. The assertion that the amount of a discharged debt of an insolvent Subchapter S corporation flows through to the shareholders and allows them to claim deductions for otherwise nondeductible losses is also flatly inconsistent with the requirements of Section 108(d)(7). That Section specifies that the amount of the discharged debt of an insolvent Subchapter S corporation is to be applied, "at the corporate level," to reduce the favorable tax attributes of the corporation. 26 U.S.C. 108(d)(7)(A). Those attributes are defined to include, *inter alia*, the "net operating losses" of the corporation for the taxable year of the discharge (26 U.S.C. 108(b)(2)(A)) which, in turn, are defined to include any "suspended" losses that the shareholders were unable to deduct for that year because they had previously exhausted their basis under Section 1366(d)(1). See 26 U.S.C. 108(d)(7)(B); note 10, *supra*.

The obvious intent of these provisions—an intent that their language plainly supports—is that the amount of the discharged debt is to be applied to reduce or eliminate the shareholders' suspended losses and does *not* pass through to the shareholders to enable them instead to deduct those same losses. As Congress emphasized in 1993 in extending these provisions to "qualified real property" loans (26 U.S.C. 108(a)(1)(D)), Section 108(d)(7) requires the amount of the discharged indebtedness to be applied to reduce favorable tax attributes "at the S corporation level" and "[t]he shareholders' basis in their stock is *not* adjusted" by that amount. H.R. Rep. No. 111, *supra*, at 624-625 (emphasis added). See also *Gaudiano* v. *Commissioner*, No. 99-1294, 2000 WL 748179, at *18-*19 (6th Cir. June 8,

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shareholders and does not ultimately yield an increased basis for the amount of the discharged debt.

2000); *Witzel* v. *Commissioner*, 200 F.3d 496, 497-498 (7th Cir. 2000), petition for cert. pending, No. 99-1693.[19] In short, a pass-through of the amount of the discharged debt to the shareholders is logically incompatible with the statutory requirement that that same amount be utilized "at the corporate level" to reduce favorable corporate tax attributes. 26 U.S.C. 108(d)(7)(A).

In particular, petitioners' interpretation of the statute would nullify the mandate of Sections 108(b)(2)(A) and 108(d)(7)(B) that the amount of the discharged debt of an insolvent S corporation be used to reduce the shareholders' "suspended" losses "for the taxable year of the discharge." 26 U.S.C. 108(d)(7)(B). See note 10,

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[19] In *Gaudiano* and *Witzel*, the Sixth and Seventh Circuits agreed with the Tenth Circuit in this case that the amount of the discharged indebtedness of the insolvent Subchapter S corporation remains "at the corporate level" and eliminates suspended shareholder losses for the taxable year of the discharge at that level. See Pet. App. 16-17 n.6, Examples 1 and 3. In those cases, however, the Sixth and Seventh Circuits went on to state that any amount of this discharged debt that remained *after* the elimination of the shareholders' suspended losses passes through to the shareholders and increases stock basis. *Gaudiano*, 2000 WL 748179, at *19-*20; *Witzel*, 200 F.3d at 497-498. As we have explained (pages 10-13, *supra*), the conclusion that a debt discharge amount that is *not* applied against the tax attributes of an insolvent Subchapter S corporation would then flow through to the shareholders as an "item of income" under Section 1366 (and thereby increase the basis of their stock under Section 1367) is based on a misconception of what "income" represents. As the language of Section 108 indicates, and as the legislative history of the Bankruptcy Tax Act of 1980 expressly states, any amount of the discharged debt of the insolvent corporation remaining after application against the suspended losses "does not result in income or have other tax consequences" and is therefore to be "disregarded." S. Rep. No. 1035, *supra*, at 2.

supra. As the Sixth Circuit correctly recognized in *Gaudiano* v. *Commissioner*, 2000 WL 748179 at *17, *18-*19, if the amount of the debt discharge were treated as an "item of income" that flowed through to the shareholders of an insolvent Subchapter S corporation under Section 1366 in the manner suggested by petitioners, "the mandated reduction of the corporation's net operating losses (which include suspended shareholder losses) would never occur since there would be no [discharged debt amount] left at the corporate level to apply against the losses." Under petitioners' interpretation of these provisions, the statutory requirement that the discharged debt amount be applied to reduce the "suspended" shareholder losses for the taxable year of the discharge could not be fulfilled. *Id.* at *28.

The facts of the present case illustrate this point. The discharge of indebtedness of the Subchapter S corporation occurred in 1991. Prior to that year, petitioners each had several hundred thousand dollars in nondeductible "suspended" losses. During 1991, the Subchapter S corporation incurred additional losses; absent an increase in shareholder stock basis, these would be "suspended" losses that could not have been deducted in "the taxable year of the discharge" (26 U.S.C. 108(d)(7)(B)). Those "suspended" losses are specifically included on the list of favorable tax attributes that Congress specified are to be reduced by the amount of the discharged debt. *Ibid.*; see note 10, *supra*. Under petitioners' reasoning, however, the discharged debt amount would *not* be used to reduce or eliminate these losses, as Congress directed, but would instead be employed to generate additional stock basis that would permit petitioners to *deduct* these very same losses. As the court concluded in this case, "[t]o

embrace the taxpayers' position is to effectively eliminate the 'price'" of tax attribute reduction that Congress imposed when it endorsed the principle that debt forgiveness for insolvent corporations does "not" constitute an item of "income" in enacting Section 108. Pet. App. 13. By depriving the tax attribution reduction requirements of Section 108(d)(7)(B) of plausible meaning, the position advocated by petitioners violates the fundamental principle that "a statute must, if possible, be construed in such fashion that every word has some operative effect." *United States* v. *Nordic Village, Inc.*, 503 U.S. 30, 36 (1992).[20]

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[20] Petitioners do not dispute that, under their approach, the reduction or elimination of suspended shareholder losses required by Section 108(d)(7)(B) can not occur whenever the debt discharge amount exceeds the amount of the suspended losses. They argue, however, that a reduction could occur in a situation where the debt discharge amount is *less* than the suspended losses (Pet. Br. 34-35). For example, if an insolvent S corporation is discharged from $100 in debt, and its shareholder has $200 in suspended losses, petitioners suggest that the debt discharge amount flows through to the shareholder, allows him to deduct $100 in losses, and then (magically) reappears at the corporate level to eliminate the *other* $100 in suspended losses. As the Sixth Circuit explained in *Gaudiano* v. *Commissioner*, *supra*, however, if the debt discharge amount passes through to and is used by the shareholder, there would be nothing left *at the corporate level* to apply against any remaining losses. See 2000 WL 748179, at *18-*19.

Even viewed in isolation from the applicable statutory text, petitioners' argument is patently illogical, for it would create an inverse relationship between the amount of indebtedness discharged and the amount of the tax attribute reduction that would occur. Under petitioners' approach, as the debt discharge amount increases, the shareholder would be able to deduct more suspended losses at the shareholder level and, as a result, the net operating loss reduction that occurs at the corporate level would be reduced.

3. The notion that the amount excluded under Section 108(a) constitutes an "item of income" that passes through the insolvent corporation to its shareholders under Section 1366(a)(1)(A) and increases shareholder stock basis in the corporation under Section 1367(a)(1)(A) is further refuted by reading Section 108(d)(7)(A) in conjunction with Section 1366(b). Section 108(d)(7)(A) provides that the debt discharge provisions for Subchapter S corporations are to be applied "at the corporate level." 26 U.S.C. 108(d)(7)(A). Section 1366(b) in turn provides that the character of an item to be passed through under Section 1366(a)(1)(A) is to be determined as if the item "were realized directly from the source from which realized by the corporation." 26 U.S.C. 1366(b). As the Tax Court explained in *Nelson* v. *Commissioner*, 110 T.C. at 122, the amount of the discharged debt, which is captured and applied "at the corporate level," cannot be treated as if it were obtained by the shareholders "directly from the source" and thus can "not pass through to the shareholders" under Section 1366. The concurring opinion of Judge Beghe in *Nelson* made the same point (110 T.C. at 131-132 (footnote omitted)):

> Section 1366(b) refutes [Nelson's] passthrough interpretation of section 108(d)(7)(A). There's no way, actually or fictively, in which the equivalence rule of section 1366(b) could apply to a solvent shareholder of an insolvent S corporation.[]

As Judge Beghe explained, since Section 108(d)(7)(A) "dictates" that the debt discharge amount be determined and applied "at the corporate level" rather than

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That absurd result would turn the tax-attribute reduction scheme enacted by Congress in Section 108 on its head.

at the shareholder level, the amount of that discharge can not "pass through to the shareholder under section 1366(a)(1)(A), and can't increase the basis of his stock under section 1367(a)(1)(A)." 110 T.C. at 134. See also Blanchard, *Debunking a Shibboleth*, 58 Tax Notes 1673 (1993).

4. Petitioners rely primarily on the decision of the Third Circuit in *United States* v. *Farley*, 202 F.3d 198 (2000) (Pet. App. 92-124), petition for cert. pending, No. 99-1675, which held that the amount of discharged debt of an insolvent Subchapter S corporation passes through to the shareholders as an item of "income," thereby increasing their basis in the corporate stock and allowing them to deduct otherwise nondeductible suspended losses.[21] In reaching that conclusion, the Third Circuit did not dispute that the taxpayer's position would result in "an apparent 'double tax bene-

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[21] Petitioners also cite (Br. 22-23 n.12, 24 n.13) various articles as support for their position. For the reasons we have described in detail, the articles that support petitioners have failed correctly to analyze the text and history of these provisions. See pages 10-13, *supra*; 1 B. Bittker & L. Lokken, *supra*, at 7-58 (the debt discharge of an insolvent Subchapter S corporation is applied against the tax attributes of the corporation and "the unabsorbed amount is not gross income and is ignored"). The cited articles do not, in any event, provide an unqualified endorsement of petitioners' contentions. For example, one of the articles acknowledges that the Commissioner's position is in "compliance with the literal language of Section 108(d)(7)(A)" and states that "[t]he problem with the taxpayer's position [is] that he want[s] something for nothing." Lipton, *Tax Court Rejects S Corp. Basis Step-Up for COD Income in Nelson*, 88 J. Tax'n 272, 277 (1998). Another article observes that the government's position "is probably correct in its results from an equitable standpoint." Williford, *Shareholder is Wrestled Down with a Full Nelson-Interplay of COD and S Corporation Rules*, 39 Tax Mgmt. Memo. 247, 257 (1998).

fit'" for the Subchapter S corporation's shareholders. 202 F.3d at 209. The court also acknowledged that there was strong evidence that the position argued by the taxpayer "may not have been the result intended by Congress." *Id.* at 212 n.10. The court nonetheless concluded that "the clear and unambiguous language" of Section 1366(a) required it to rule in the taxpayer's favor because, under that provision, "all income, tax-exempt or otherwise, passes through to the shareholders of an S corporation" and thereby "increases the shareholder's basis in their [S corporation] stock." *Id.* at 209, 210.

In so holding, however, the Third Circuit failed to give effect to the plain language of Section 108(a) which incorporates the longstanding rule that the discharge of indebtedness of an insolvent corporation does "not" represent "income" because it effects no gain or accretion of wealth for the taxpayer. 26 U.S.C. 108(a)(1)(B). See pages 10-13, *supra*. The court also failed to acknowledge the role of Sections 108(b) and 108(d)(7)(A), which require the amount of the discharged debt to be applied, "at the corporate level," to reduce the favorable tax attributes of the insolvent corporation (see note 10, *supra*) and that any "remaining debt discharge amount" is then to be "disregarded" for it "does not result in income or have other tax consequences." S. Rep. No. 1035, *supra*, at 2.

In particular, the decision of the Third Circuit in *Farley* would nullify the statutory mandate that the amount of the discharged debt of an insolvent corporation be applied "at the corporate level" to reduce or eliminate the shareholder suspended losses for "the taxable year of the discharge." 26 U.S.C. 108(d)(7)(A),(B). The court acknowledged in *Farley* that Section 108(d)(7)(B) specifies that the suspended losses that

accrue in the year of the discharge of indebtedness are to be treated as part of the "net operating losses" of the Subchapter S corporation. The court erred, however, in stating that this statute does not "indicate" that the amount of discharged debt "should *reduce* such net operating losses '*for the taxable year of discharge.*'" 202 F.3d at 207. The statute, in fact, *expressly* imposes that requirement by specifying, in Section 108(b)(2)(A), that the amount of the discharge of indebtedness is to be applied to reduce "[a]ny net operating loss for the taxable year of the discharge." 26 U.S.C. 108(b)(2)(A).[22] As other courts have noted, by interpreting the statute to pass the debt discharge amount through to the shareholders under Section 1366, the decision in *Farley* would allow the shareholders to deduct the very same "suspended" losses that the statute instead directs are to be reduced (or eliminated) "at the corporate level" under Section 108(b). *Witzel* v. *Commissioner*, 200 F.3d at 497; *Gaudiano* v. *Commissioner*, 2000 WL 748179, at *18-*19; pages 27-29, *supra*.

Perhaps recognizing that its decision would allow suspended losses in the year of the discharge to escape the attribute reduction required by Congress in Section 108(b), the Third Circuit suggested that "the tax attribute reduction scheme set forth in Section 108(a)-(b)" can instead be "implemented by reducing" *other* tax attributes listed in Section 108(b), such as "the basis of an S corporation's assets." 202 F.3d at 207-208. The

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[22] It is, of course, implausible that Congress would have taken the trouble to define Subchapter S corporation "net operating losses" for purposes of Section 108(b)(2)(A) to include the "suspended" losses incurred by shareholders in the year of the discharge (26 U.S.C. 108(d)(7)(B)) if Congress believed that those losses were, as the court held in *Farley*, never to be reduced.

possibility that the court's holding in *Farley* would not nullify *all* parts of the tax attribution reduction scheme of the statute, however, plainly does not justify the court's nullification of Section 108(d)(7)(B).

Moreover, the Third Circuit's reasoning ignores the express ordering provisions that Congress adopted for application of the tax attribute reduction scheme. Congress specified in Section 108(b) that (absent a specific election by the taxpayer) the amount of the discharged debt is to be applied *first* to reduce the net operating losses of the insolvent corporation (Section 108(b)(2)(A))—which expressly includes the "suspended" losses of the shareholders (Section 108(d)(7)(B))—and only *thereafter* is to be applied to reduce *other* tax attributes such as business credits or the basis of the assets held by the corporation. 26 U.S.C. 108(b)(2)(A)-(G).[23] See note 10, *supra*. The reasoning of the court in *Farley* is flatly inconsistent with this statutory directive that suspended losses in the year of the discharge be the *first* tax attribute reduced by the discharged debt under Section 108(b).

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[23] In describing these "ordering rules," Professors Bittker and Lokken state (1 B. Bittker & L. Lokken, *supra*, at 7-59):

> A bankrupt's or insolvent's debt discharge income is first subtracted from its net operating loss * * * for the taxable year in which the discharge occurs * * * . The theory underlying this reduction is as follows: By reason of the debt discharge, losses sustained by the taxpayer have been borne by the taxpayer's creditors. Normally, this would be reflected by requiring that the taxpayer recognize gross income in the year of the discharge to offset its earlier deductions of the shifted losses. However, because the losses have not yet yielded tax benefit, this rule simply shaves down the loss deductions to eliminate portions not ultimately borne by the taxpayer.

5. Petitioners further err in contending (Pet. Br. 35-41) that Section 108(b)(4)(A) of the Code supports their position in this case. Although the Tenth Circuit discussed that provision at some length in its opinion (Pet. App. 14-16), that statute has no bearing on the proper disposition of this case.

Section 108(b)(4)(A) provides a rule with respect to the timing of the attribute reductions mandated by Section 108(b). The statute provides that those reductions "shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge." 26 U.S.C. 108(b)(4)(A). In practice, this means that the amount of the discharged debt is not to be taken into account by an insolvent taxpayer, and results in no reduction of its tax attributes, until after the tax for the year of the discharge is determined.[24]

This requirement that the reduction in the insolvent taxpayer's tax attributes under Section 108(b)(4)(A) "shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge" (26 U.S.C. 108(b)(4)(A)) applies at the corporate level, not to petitioners as shareholders of the corporation. 26 U.S.C. 108(d)(7)(A). Nothing in Section

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[24] If the taxpayer elects under Section 108(b)(5) first to reduce its basis in depreciable property in lieu of reducing the attributes in the order prescribed by Section 108(b)(2) (see note 10, *supra*), the basis reduction takes effect under Section 1017 not "after the determination of the tax imposed * * * for the taxable year of the discharge" (26 U.S.C. 108(b)(4)), but, instead, "at the beginning of the taxable year following the taxable year in which the discharge occurs" (26 U.S.C. 1017(a)). The timing of the basis reduction in the event of this election was chosen "[in] order to avoid interaction between basis reduction and reduction of other attributes * * * ." H.R. Rep. No. 833, 96th Cong., 2d Sess. 11 (1980); S. Rep. No. 1035, *supra*, at 14.

108(b)(4)(A) addresses the question whether petitioners may take an amount that is "not" income under Section 108(a) and treat it as an "item[] of income" for the entirely different purposes of Section 1366. Instead, by deferring the attribute reduction under Section 108(b)(4)(A) until "after" the end of the tax period, the statute *ensures* that the amount of the discharged debt of the insolvent corporation will be used to reduce or eliminate the shareholder "suspended" losses "for the taxable year of the discharge" (Section 108(d)(7)(B)) and thereafter be applied to reduce other tax attributes of the corporation. See pages 27-29, *supra*.

Certainly, nothing in Section 108(b)(4)(A) can plausibly be said to be designed or intended to place any taxpayer in a *better* position than he would have been in had the discharge of indebtedness never occurred. As the Tenth Circuit observed in this case, "[t]o embrace [petitioners'] position is to effectively eliminate the 'price' Congress imposed upon entities whose discharged debt income is excluded under § 108." Pet. App. 13. The court of appeals correctly concluded that petitioners' effort to convert a statute that was enacted to *reduce* tax benefits into a provision that confers the "unwarranted windfall" of a double tax benefit is refuted by the text, purpose and history of these provisions. *Id.* at 16.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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